

TALES FROM THE TRENCHES™

BY BARRY C. MCGUIRE

November, 2013

HOLDBACKS OR DRAWBACKS?

In a recent situation our investors wanted to purchase a property that obviously needed renovation work to the heating and electrical system, which included three furnaces (one in the garage). The roof also needed re-shingling. Their inspector told them what work needed to be done; they consulted with plumbing, roofing, and electrical contractors, and produced a list of deficiencies that they wanted the seller to remedy within a specific time.

The seller said he would take care of the deficiencies and then he didn't. Arguments ensued about what was really required and who would be the judge of whether the jobs were properly done. The two weeks given to the seller to fix the deficiencies was extended by three more two-week periods. Now we are at two months after signing the offer to purchase and still nothing done.

Our investor had a fully approved mortgage and, in fact, the lender had funded the mortgage based on the original closing date and we had to send the mortgage money back to them. The lender is starting to ask questions. The seller throughout had been uncooperative and, to be charitable, not forthright in providing all the information on the property or the existing three tenants and their information.

Our investor decides on a change of tactic. If the seller won't fix the deficiencies, then let's put a value on the deficiencies and do a repair holdback. Give the seller a little more time to do his job and then if he doesn't, I will have the money to do it. That is our investors thinking. Nothing wrong with that, right?

There are two major issues that come up at this point:

Firstly, our investor needs a repair holdback clause.
And secondly, what about the lender?

Holdbacks are when your purchase contract requires the seller to do or fix something before closing. Maybe s/he has to do take away some junk or old car bodies or perhaps complete a renovation. No matter what the seller has to do, your contract needs:

1. a precise description of the seller's obligation,
2. a time by which the obligation must be completed,
3. a money consequence (holdback) for failure to complete the seller's obligation, and;
4. how and when and who controls the release of holdback.

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Compare the following two clauses. The first was prepared by our client's realtor and sent to me for review. The second is my amended clause.

Original clause:

The seller agrees to obtain at their cost and provide to the buyer no later than seven days prior to the completion date, proper permits and certification for the heating systems and electrical systems within the property.

Amended clause:

The Seller Agrees to Obtain at their Cost and provide to the buyer no later than seven days prior to the completion date, all required permits for both the electrical and heating systems and components of those two systems as currently installed in the property and proof that both systems have final inspection and approval by the City of Edmonton. In the event such permits and final inspections are not provided seven days prior to the completion date, the buyer will complete the purchase and hold back \$10,000 from the closing proceeds. The seller will have a further 30 days commencing on the day after the Completion Date to provide the permits and final inspections. If, after the expiry of the extra 30 days the permits and final inspections have not provided by the seller, the \$10,000 holdback will be released to the buyer and the responsibility for permits and final inspections will shift to the buyer. No money will be refunded to the seller.

The lender approved the mortgage on the basis of the original offer where the seller fixed and paid for the deficiencies. Lenders do not like cash backs, repair holdbacks, or repair credits. Experience has shown lenders that these types of monetary adjustments are often a scam and an attempt by purchasers to reduce the amount of cash they have to put into a property.

So, lenders often take a very straightforward position. Cash backs, repair holdbacks, and repair credits are just a reduction in the purchase price. If the price is reduced then the amount of mortgage money is reduced. Lenders instruct their lawyers to watch out for these items and advise the lender if they occur.

We did advise the lender through the mortgage broker on the file and surprisingly the lender was more lenient than most. Deficiencies were completed, paid invoices supplied, and the surplus of holdback monies returned to the lender for application against the mortgage principal. In my view this lender attitude is rare and our investor was fortunate.

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Lessons Learned:

1. The first clause is useless because it does not contain
 - a) a precise description,
 - b) time to complete,
 - c) a money consequence/defined dollar holdback, or
 - d) how the money gets released if the seller's obligation isn't met.The second clause meets all four requirements.
2. In genuine repair situations, your best bet is to have the seller actually do the work before closing. This maximizes your mortgage amount and still gets the repairs done.
3. Heads up, lenders hate holdback clauses whether they be cash back, repair credits or repair holdbacks. Many lenders have a policy that any holdback is a reduction in the purchase price and therefore a reduction in the mortgage amount.
4. If your real estate purchase contract needs a holdback, consult with your mortgage broker/lender and with your lawyer to make sure the holdback will be allowed and the holdback clause is properly drafted.
5. Always best to have the seller's obligation completed well before the closing day. Try for 14 days. You will be happier and your lender will certainly be happier.

JOINT VENTURES 2.0

If Joint Ventures are on your radar, it's time to get going!

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